IFRS

STAFF PAPER

April 2021

IASB® meeting

Project	**Financial Instruments with Characteristics of Equity (FICE)**		
Paper topic	Disclosures—priority on liquidation		
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Introduction

1. At its February 2021 meeting, the Board discussed potential refinements to disclosure proposals explored in its 2018 Discussion Paper *Financial Instruments with Characteristics of Equity* (the 2018 DP). In this paper, the staff continue to discuss further refinements to the proposals for priority on liquidation disclosures.

2. The discussion at the February 2021 meeting largely focused on the scope of the disclosures in light of stakeholder concerns relating to disclosure overload and the costs of preparing the disclosures. One of the main suggestions raised at that meeting was for the staff to clearly define the objectives of the disclosures based on the information needs of users of the financial statements and determine the scope that best meets those objectives.

3. This paper is structured in the following way:

   (a) information needs of users of financial statements (paragraphs 4–7);

   (b) staff's research on information available outside the financial statements (paragraphs 8–9);

(c) disclosure objectives (paragraphs 10–12);

(d) disclosure of company's capital structure (paragraphs 13–21);

(e) disclosure of priority of particular instruments (paragraphs 22–47);

(f) illustrative examples (paragraph 48);

(g) staff's recommendations (paragraph 49); and

(h) question for the Board (paragraph 50).

Information needs of users of financial statements

4. Based on what we heard from users of the financial statements, their information needs can be placed into two categories:

   (a) the need for greater visibility regarding the company's capital structure; and

   (b) the need to understand priority on liquidation of particular instruments to estimate the risk and return on the instruments.

5. With respect to paragraph 4(a) of this paper, investors said that they would like more information about the capital structure of a company. This feedback was given in the context of discussing the 2018 DP's proposal for a list of all financial liabilities and equity instruments in the order of their priority on liquidation of the entity.

6. Historically, the core part of analysing the company's capital structure was understanding the debt-to-equity ratio. However, many companies today have more complex capital structures because they have issued financial instruments that combine features of debt and equity and have different levels of subordination. Investors told us that financial innovation has led to new ways of shaping the distributions of risks and cash flows. This innovation has not only challenged traditional liability and equity concepts but has also led to increasing efforts to obscure the nature of the claims against company assets as well as the risk and reward distributions inherent in those claims. Better understanding of a company's capital structure and subordination within the structure will enable investors to better assess the strength of the company's financial position, the

nature of the claims against the company's assets, and how those claims affect the liquidity and solvency of the company.

7. With respect to paragraph 4(b) of this paper, there were some users of financial statements who wanted to understand the relative ranking of particular financial instruments should the issuer become insolvent. Such information would help existing and future investors determine the risk of losing their investments and the value of the instruments in such scenarios. In particular, some investors mentioned that such information would be particularly useful in analysing downside scenarios and how potential economic shortfalls would be allocated to particular instruments.

Staff's research on information available outside the financial statements

8. As discussed in Agenda Paper 5A of this meeting, the staff conducted research to understand the types of information that are generally available to investors based on listing requirements that apply when securities are initially offered to the public or admitted to trading on a regulated market. These disclosures are not part of the financial statements and may not be subject to the same financial reporting processes and controls as the information reported in the financial statements. We also acknowledge that not all instruments are listed and some offers of transferable securities to the public are exempt from the obligation to publish a prospectus. Nevertheless, many stakeholders including investors noted that information about priority on liquidation of particular instruments is often available in prospectuses and/or other offering documents. For this reason, some investors considered the priority information as 'a nice to have rather than a must have' especially when these underlying documents are readily available.

9. The staff therefore set out to understand the types of supplementary information related to priority on liquidation which investors typically have access to. Among others, the staff noted that the issuer could be required to include information in the prospectus about:

    (a) the issuer's capital resources (both short term and long term) including an explanation of the sources, amounts, and a narrative description, of the issuer's cash flows, the borrowing requirements and funding

structure of the issuer, any restrictions on the use of capital resources and the anticipated sources of funds needed to fulfil particular commitments;

(b) a statement of capitalisation and debt (distinguishing between guaranteed and unguaranteed, secured and unsecured) as of a date no earlier than 90 days prior to the date of the document. The term 'debt' also includes indirect and contingent debt;

(c) a description of the rights of equity securities to share in any surplus in the event of liquidation; and

(d) the relative seniority of the securities in the issuer's capital structure in the event of insolvency, including, where applicable, information on the level of subordination of the securities and the potential impact on the investment in the event of a resolution of credit institutions and investment firms.

See Agenda Paper 5A of this meeting for other information provided to meet general listing requirements.

Objective of the priority on liquidation disclosures

10. To date, we have explored ways to meet the two categories of needs described in paragraph 4 of this paper using the same set of disclosures. In this paper, we consider whether those information needs of users of the financial statements would be better met by two separate sets of disclosures that each address the respective needs.

11. A set of disclosure requirements can be developed to address the information needs described in paragraph 4(a) of this paper with respect to the company's capital structure. The objective of this set of disclosures is to enable investors to better understand an entity's capital structure facilitating the assessment of the strength of the company's financial position, the nature of the claims against the company's assets and how those claims affect the liquidity and solvency of the company.

12. Another set of disclosure requirements can be developed to address the information needs described in paragraph 4(b) of this paper with respect to the priority of particular instruments. The objective of this set of disclosures is to help investors understand the risks and returns on particular instruments relative to others in the event the issuer is liquidated.

Disclosure of company's capital structure

13. In order to help investors better understand an entity's capital structure, the staff think an entity should be required to disclose information about its capital structure, including a disaggregation into categories of capital that will enable users of financial statements to understand the nature of the entity's capital structure and the quality of the different categories of capital.

14. We think the disclosure requirements in this regard should not rigidly define what an entity must regard as its capital structure or the way an entity needs to categorise its capital structure. Investors have asked the Board to avoid creating further accounting taxonomies and hierarchies for the capital structure, as preparers and users already have to manage complex regulatory overlays to contractual terms, especially for companies in the financial services sector. The staff therefore believe it would be more effective to require an entity to provide an explanation of what is regarded as part of its capital structure and the way they categorised it.

15. IFRS Standards do not define 'capital structure' and 'capital'. However, in general terms, an entity's 'capital structure' refers to the particular combination of debt and equity used by an entity to finance its overall business activities and operations. The staff recommend that in describing its capital structure, an entity considers its funding/financing structure when determining what it regards as part of its capital structure. We expect that an entity would consider debt and equity instruments issued that arise from financing activities as defined by IAS 7 *Statement of Cash Flows*. This would not however preclude an entity from including as part of its capital structure, other instruments that it considers as part of its capital structure for example working capital finance from supplier financing.

16. In disaggregating its capital structure to reflect the difference in the quality of the capital in each category, an entity could use its own judgment including deciding on the terminology it uses to describe the various categories of capital. A number of factors will influence the quality of the capital of an entity, for example subordination, collateralisation and loss-absorbing capacity. However, to meet the needs of users of financial statements, the staff think at a minimum, an entity should be required to categorise its capital structure in a way that distinguishes between:

    (a) secured and unsecured financial instruments;

    (b) contractually subordinated and unsubordinated financial instruments; and

    (c) those issued/owed by the parent and those issued/owed by subsidiaries.

17. One way to categorise financial instruments that make up the entity's capital structure and to meet the requirement in paragraphs 16(a)-(b) of this paper is by liquidation preference, for example senior secured debt, senior unsecured debt, subordinated debt, 'hybrid capital' (which includes contingent convertible bonds and perpetual instruments), preferred shares and ordinary shares.

18. The staff think it would be useful to distinguish instruments issued/owed by the parent from those instruments issued/owed by subsidiaries. For a group preparing consolidated financial statements, many users of financial statements told us that they would like to understand which entity within the group issued the financial instruments. Many of them said it would be helpful to understand whether the financial instruments have been issued by the parent or the subsidiaries especially due to the existence of structural subordination. If a group already prepares separate financial statements for the parent entity, that information should already be available. The group could distinguish between the financial instruments issued/owed by the parent and those issued/owed by subsidiaries collectively for each category of capital.

19. For banks and other financial institutions, disaggregation based on the loss absorption capacity of capital instruments may be more useful, for example, Common Equity Tier 1, Additional Tier 1 and Tier 2 instruments. This is because financial institutions already provide disclosures using these categories for

regulatory purposes. This would also be in line with the preliminary discussions the Board had in February 2021 about providing priority disclosure on a resolution basis rather than on a liquidation basis, where this is more relevant to entities that are subject to resolution regime. However, disaggregation of capital by quality of regulatory capital instruments does not include all debt instruments issued and does not include information about whether the instruments are secured or unsecured. Additional information should then be provided to meet the requirement described in paragraph 16 of this paper.

20. The objective of this disclosure is not to provide information about the priority of individual instruments on liquidation. As an entity will not be required to disclose a relative ranking of each financial instrument, the information can be provided on a consolidated and aggregated basis. That is, a preparer would not have to assume the scenario in which the whole group is liquidated, which was one of the significant challenges raised with respect to the proposals in the 2018 DP. The preparer is merely categorising its capital structure to show differences in the quality of capital within that capital structure.

21. Disclosure about the disaggregation of the capital structure should be based on the carrying amounts as at the reporting date. In addition, if it is not otherwise clear, it should be made clear in which line item in the statement of financial position the instruments are included so that investors can relate the amounts back to the consolidated financial statements.

Priority of particular financial instruments on liquidation of the issuer

22. In order to meet the second type of need—to understand risks and returns of investing in particular instruments—more targeted scoping may be appropriate. For example, to understand the risk to the holder of not recovering the full amount of the investment on liquidation of the issuer, additional disclosures can be required for financial instruments for which there are greater risks of loss in such an event. Some investors in senior bonds and instruments issued by highly rated companies told us they are relatively less concerned with priority information and potential losses resulting from liquidation of the issuer. This is because they perceive such risks to be low. In addition, some investors in ordinary shares told

us they were not interested in understanding the priority of the issuer's instruments because it was clear that they rank last.

23. Before discussing the level of detail to be disclosed to meet the second type of need, the staff first considered whether the disclosure should be required for particular types of entities and which instruments should be scoped into the disclosure requirements.

Should the disclosure be required only for entities with financial difficulties?

24. The stakeholder feedback suggests that information about priority on liquidation is more relevant when entities are experiencing financial difficulties and therefore at greater risk of going into liquidation. In addition, some stakeholders questioned the importance of information about priority on liquidation when financial statements are prepared on a going concern basis. The staff therefore considered whether the priority disclosures should only be required for entities that are experiencing financial difficulties or in liquidation.

25. It may be possible to define the scope such that these disclosures are provided for companies that are preparing their financial statements on a liquidation basis or when a company identifies and discloses material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern (in accordance with the requirements in IAS 1 *Presentation of Financial Statements*). However, the staff think such a point in time would be too late for such information to be decision-useful for investors and/or potential investors. In addition, the staff acknowledge that IFRS Standards do not apply to financial statements prepared on a basis other than going concern.

26. To mitigate the timing issue, this disclosure could be required at an earlier stage, for example when a company is experiencing significant financial difficulties. However, such status is difficult to define clearly and may be too subjective to enforce. Entities that are experiencing significant financial difficulties may also be disincentivised to provide the disclosure as this could been seen as an early warning to investors of the entity's financial difficulty. The staff believe information about priority on liquidation would also be equally useful to investors

of entities that prepare their financial statements on a going concern basis. We therefore recommend that the disclosure should be required for all entities.

Should the disclosure be required only for particular types of financial instruments?

27. The staff considered whether the disclosure should be provided for particular types of financial instruments. We identified a number of feasible alternatives:
    (a) **Alternative A:** equity instruments other than ordinary shares. Ordinary shares are generally the most subordinated instruments.
    (b) **Alternative B:** subordinated liabilities and equity instruments other than ordinary shares.
    (c) **Alternative C:** align the scope of the priority disclosures with the scope of the terms and conditions disclosures (ie financial instruments with characteristics of both debt and equity including compound instruments).

28. ***Alternative A*** responds to investor feedback that there is generally less information disclosed about equity instruments compared to financial liabilities that are subject to more comprehensive disclosure requirements in IFRS 7. Some investors said it would be useful to understand how a surplus or deficit in the entity's economic resources on liquidation would be distributed/allocated amongst the holders of different types of equity instruments. However, based on the overall investor feedback, the staff think that the demand for priority information is at least equally strong for holders of subordinated financial liabilities.

29. In addition, we note that IAS 1 requires disclosure of the rights, preferences and restrictions attached to each class of share capital including restrictions on the distribution of dividends and the repayment of capital.[1] Some entities currently provide priority information for different types of equity instruments to meet this requirement. Alternative B and C would therefore better respond to stakeholder needs than Alternative A. Little incremental information will be provided if the scope of this disclosure is limited to equity instruments only.

[1] Paragraph 79(a)(v) of IAS 1

30. ***Alternative B*** is based on a process of scoping out the financial instruments for which priority on liquidation was less contentious. Investors in senior bonds and those that invest in ordinary shares were less concerned about priority on liquidation because their priority is clear. Priority matters more to the holders of subordinated liabilities and equity instruments other than ordinary shares because of the level of risk that they would incur losses on liquidation of the entity.

31. Subject to the Board's decision on the scope of disclosure on terms and conditions (see Agenda Paper 5A for this meeting), **Alternative C** could be based on financial instruments with features of both debt and equity and Alternative B could be a subset of Alternative C. If subordination is considered one of the equity-like features (as proposed in Agenda Paper 5A for this meeting), subordinated liabilities will be considered to have features of both debt and equity. Similarly, equity instruments other than ordinary shares could likely have debt-like features such as a fixed % coupon (that can be cancelled or deferred until liquidation).

32. The main difference would be that Alternative C would include compound instruments such as convertible debt instruments, whereas Alternative B would not because Alternative B focuses on the financial instruments that are at the lower-end of the 'distribution waterfall' ie subordinated liabilities and equity instruments other than ordinary shares. Alternative C would therefore respond to the feedback from some investors that they would like to understand the key terms and conditions (including priority on liquidation) of compound instruments as a whole ie before splitting the compound instrument into liability and equity components.

33. In addition, aligning the scope means that information about priority on liquidation can be provided as part of the terms and conditions disclosure. This would alleviate some of the concerns about disclosure overload and would also provide the relevant information in one place because in order to assess the risks and returns on a financial instrument, investors would need to understand other key terms and conditions as well as its priority on liquidation. The staff's preference is ***Alternative C***. In our view, Alternative C achieves the best balance between providing useful information to investors about the instruments for which

priority on liquidation is particularly relevant to them and limiting the burden for preparers.

34. In determining for which financial instruments the priority information should be disclosed, the staff also considered but rejected the following alternatives:

Scope	Reasons for rejection
All liabilities and equity instruments issued	This may be too onerous as it would include all non-financial instruments and would be too broad as it would include the most senior instrument and the most subordinated instruments for which priority is not contentious.
All financial liabilities and equity instruments issued	This may be too onerous as it would include operating liabilities like trade payables and is too broad as it would include the most senior instrument and the most subordinated instruments for which priority is not contentious.
Financial liabilities and equity instruments from financing activities	The scope may be too broad as it would include the most senior instrument and the most subordinated instruments for which priority is not contentious.
Only particular financial liabilities and equity instruments that are potentially dilutive	The scope would be too narrow as it would only include financial instruments that could be settled in own shares. Priority information would be equally, if not more, important for financial instruments that are settled in cash or other financial assets.
Only particular financial liabilities and equity instruments that users of financial statements find difficult to understand their classification	This category might not capture all financial instruments for which priority information is particularly relevant. In addition, this would be highly subjective and difficult to scope.

Only particular financial liabilities and equity instruments that change priority on liquidation or a pre-liquidation event like resolution	This alternative may only address a narrow set of financial instruments. For example, capital instruments issued by financial institutions that absorb losses on the occurrence of a specified event. A conversion to ordinary shares or a write-down of the principal amount can be viewed as a change in priority on that specified event. Other instruments do not necessarily change priority on liquidation but they have different features on liquidation eg equity classified but similar to debt instruments the obligation on liquidation is for a fixed amount. This set of instruments would also be scoped in by Alternative C described in paragraph 31 of this paper.

What information should be disclosed?

35. As discussed above, the staff think the information about priority on liquidation should be combined with the terms and conditions disclosure (see Agenda Paper 5A for this meeting). For the information to be useful to users of the financial statements and meet the disclosure objective entities need to provide both quantitative and qualitative information.

36. Quantitative information would help the users identify the extent of instruments included in the scope of the disclosures. Consistent with the terms and conditions disclosures, the information should be disclosed for material financial instruments. In the consolidated financial statements, materiality should be considered in the context of the whole group.

37. As discussed at the February 2021 Board meeting, most stakeholders including users of the financial statements said that they preferred the priority on liquidation disclosures to be based on carrying amounts. Some stakeholders acknowledged that recoverable amounts would be most useful but that it would be difficult, if not impossible, to determine the amounts that would be recoverable on liquidation with certainty at the reporting date.

38. Similar to paragraph 21 of this paper, the disclosure should be provided based on carrying amounts and it should be made clear in which line item in the statement of financial position the instruments are included.

39. Qualitative information that may be disclosed could include the following:

    (a) terms and conditions that indicate priority on liquidation or that could lead to changes in priority (eg conversion features and contingent features) including whether the application of relevant laws or regulations may result in uncertainty in how the priority will be determined at liquidation (see paragraphs 40–43);

    (b) multiple subordination levels that exist within a particular category of capital. By category, we mean by type of financial instrument with characteristics of both financial liabilities and equity (eg subordinated liabilities, hybrid capital/perpetual instruments) (see paragraphs 44–46); and

    (c) description of intragroup arrangements such as guarantees that are relevant to understand the priority of material financial instruments (see paragraph 47).

Terms and conditions relating to priority on liquidation

40. In order to meet the objective described in paragraph 7, entities would be required to disclose terms and conditions that are relevant to understanding the particular instruments' priority on liquidation of the entity or similar events as described in the contracts of the relevant financial instruments (for example, insolvency, dissolution, administration, bankruptcy, moratorium or resolution). The entity would be required to disclose to which instruments or obligations of the issuer the financial instruments rank junior and senior to. For example, an entity may disclose that its subordinated liabilities rank junior to other unsubordinated liabilities of the issuer and rank senior to ordinary and preference shares of the entity.

41. Some financial instruments may contain terms and conditions that lead to changes in priority on the occurrence of a particular event. For example, a financial instrument may be converted into lower priority financial instruments such as

ordinary shares or written-down in the event of the issuer's resolution. Such information will respond to the request from users of the financial statements to be able to assess the risk of losing their investments in such scenarios.

42. In describing the financial instrument's priority on liquidation, contracts generally include a caveat relating to how particular laws and regulations may affect the priority of financial instruments, for example, one of the clauses in a prospectus for a senior note reads:

> '[…] the payment obligations of the Issuer under the Notes and the Receipts and Coupons relating to them and of the Guarantor under the Guarantee shall, **save for such exceptions as may be provided by the laws of bankruptcy and other laws affecting the rights of creditors generally**, […] at all times rank at least equally with all their respective other present and future unsecured and unsubordinated obligations.'

43. In the staff's view, disclosure of such caveats would not likely be useful to users of financial statements due to their generic nature. We think it would be more useful to users of financial statements if disclosures were required when there is significant uncertainty about the application of relevant laws or regulations that could affect how priority is determined. Consistent with the Board's discussion in February 2021, in such cases, entities should not be required to predict what legal outcomes at liquidation may be in providing this disclosure.

Multiple levels of subordination within a category

44. The staff reviewed a number of prospectuses to understand how much information about an instrument's priority on liquidation is generally provided. Based on our review, we found that some financial instruments rank pari passu with other instruments in the same category while in other cases, the financial instruments rank ahead of or below other instruments in the same category. For example, some subordinated notes rank junior to other subordinated notes. In other cases such as securitisations, instruments can be issued in multiple tranches, each having a subordination ranking.

45. Some investors said that for priority information to be useful, it should be provided at a sufficiently granular level, eg priority of each tranche of a particular instrument. Many other investors and other stakeholders acknowledged that they do not expect all the useful information in the annual report, especially when similar information that is available on-line is more comprehensive and up-to-date. They added that many investors access the terms and conditions in the prospectus for the financial instruments. They said better availability of these prospectuses on-line should be required instead of attempting to include all terms and conditions in the financial statements or a highly summarised version.

46. In the staff's view, disclosure of priority at such a granular level might be useful for the investors in particular financial instruments but may not be useful for the general users of the financial statements. Furthermore, it would likely add a high volume of additional information that may lead to a disclosure overload problem. We think, when there are multiple levels of subordination within a category, an entity should be required to disclose that instruments do not rank pari passu with one another in that category. In this way an entity can alert investors about the existence of multiple levels of subordination within a particular category of financial instruments and investors would be able to decide whether to perform further analysis of subordination for the particular instruments by reviewing the underlying documents. While we acknowledge investors' feedback about the needs for better accessibility to the underlying documents, we do not think that it is appropriate for IFRS Standards to include a requirement on what information an entity should make available outside the financial statements or where to find that information.

Description of intragroup arrangements

47. Intercompany guarantees or similar arrangements may affect the priority of the financial instruments that are subject to those guarantees. Such information would be useful to the users of the financial statements to assess the risks of losing their investments at liquidation of the issuer and should therefore be disclosed. Depending on the materiality and the number of such arrangements, the level of detail disclosed could vary. At a minimum, an entity should describe which entities are providing and receiving guarantees and how it affects the priority of the relevant instruments.

Illustrative example

48. Consider the following example.

Note 20 Capital Structure

As at 31 December 2020, Company X's capital structure is made up of the following financial instruments.

	As of 31 Dec 2020		
	Consolidated	Issued by parent	Issued by subsidiaries
Senior secured debt (a)	1,200	-	1,200
Senior unsecured debt (a)	500	-	500
Subordinated liabilities (see note 15)	500	500	-
Classified as financial liabilities	*2,200*		
Perpetual notes (see note 18)	200	200	-
Irredeemable preference shares (See note 19)	500	400	100
Non-controlling interest	1,250	-	1,250
Shareholders' equity	8,500	3,350	-
Classified as equity	*10,450*		
Total	***12,650***		

(a) They are included in the 'Borrowings' line item in the statement of financial position.

Note 15 *Subordinated liabilities*

	As of 31 Dec 2020
EUR100mil 7.125% subordinated notes due 2025	85
GBP250mil 6.75% subordinated notes due 2030	250
USD225mil 7.20% subordinated notes due 2033	165
Total subordinated liabilities	500

Subordinated notes rank behind senior debt and all other unsubordinated obligations of Company X and rank senior to the company's ordinary shares, preference shares and perpetual notes.

[other key terms and conditions, for example, equity-like features in these instruments and the features that determine their classification]

Staff's recommendations

49. Based on the analysis set out in this paper, the staff recommend the following disclosures to be incorporated into IFRS 7 to meet the objectives set out in paragraph 4:

    (a) An entity would be required to disclose its capital structure disaggregated into categories to enable users of the financial statements to understand its capital structure and the quality of different categories of capital.

        (i) In disclosing its capital structure, an entity would consider the particular combination of financial liabilities and equity instruments used to fund/finance its overall business activities and operations.

        (ii) In disaggregating its capital structure to reflect differences in the quality of its capital, an entity would use its own judgment, including determining the terminology it uses to describe the various categories of capital but at a minimum, it would be required to categorise them in a way that distinguishes between:

            1. secured and unsecured financial instruments;

            2. contractually subordinated and unsubordinated financial instruments; and

            3. those issued/owing by the parent and those issued/owing by subsidiaries.

    (b) An entity would be required to provide information about priority on liquidation of financial instruments that have characteristics of both financial liabilities and equity instruments. The priority information should be provided as part of the terms and conditions disclosures and should include the following:

        (i) terms and conditions that indicate priority or that could lead to changes in priority (eg conversion features and contingent features) including when there is significant uncertainty about the application of relevant laws or

regulations that could affect how priority will be determined at liquidation;

(ii) when multiple subordination levels exist within a particular category[2] (eg subordinated liabilities, perpetual instruments); and

(iii) describe intragroup arrangements such as guarantees that are relevant to understand the priority of material financial instruments.

(c) An entity would provide the above information based on the carrying amounts of the instruments and if not otherwise clear, state in which line item in the statement of financial position the instruments are included.

Question for the Board

50. The staff would like to ask the Board the following question.

Question for the Board
Does the Board agree with the staff's recommendations set out in paragraph 49 of this paper?

[2] Category means type of financial instrument with characteristics of both financial liabilities and equity